Multi-Asset Portfolios

Top Down Views from Amundi Research

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Moving towards a late-cycle financial regime

Central banks' "beautiful" normalisation of balance sheets and rates will drive the **transition from a reflationary into a late financial cycle regime** against a backdrop of consolidating growth (from both a macro and micro fundamental standpoint) and subdued inflation. The global economic recovery is not yet complete and accommodative monetary policy is still needed to allow policy implementation, support activity and eventually boost inflation. Benign economic conditions eventually passed through global EPS growth. In 2017, the recovery in global profits has been strong and well spread across regions. Based on our projections, we expect global EPS growth to consolidate around 10% on average. We think that the different stance of the EPS cycle is a good marker for our mid-term equity allocation. In the US, limited pressure on wages has underpinned margins while the dollar's overall depreciation in 2017 allowed some further momentum in the most recent reporting season. We expect US EPS to post around 10% year-on-year growth (tax reform excluded). The catch-up recovery in European profits will be supported by the expectations of higher rates and curve steepening, benefiting the financial sector in particular. EM earnings will eventually bottom out; Japan is surprising to the upside on tangibly improving fundamentals, independent from the yen (which, however, remains crucial).

In absolute terms, valuation on fixed income and equity are stretched on average. Global markets have, in fact, already priced in a good chunk of economic improvements. Opportunities need to be exploited on a country, style and sector basis to find pockets of value. However, we expect equity multiples to hold firm if the lift in interest rates is smooth and contained, and profits continue to consolidate, as typically occurs during a late financial cycle regime.

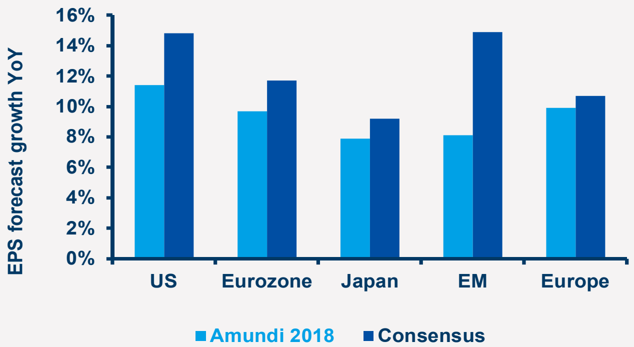
The **risk premia** on IG and HY credit are well above the historical average due to the impressive spread compression and low carry, which should eventually allow some rotation from HY into equity. Unprecedentedly low interest rates are keeping relative value considerations in favour of equities vs govies. On the latter, the extraordinarily low rate environment leaves fixed income vulnerable as the small coupons imply severe initial conditions should a bond bear market start.

Positioning and flows are key tactical factors that will influence and magnify the markets' correction. At present, while there has been a re-positioning out of global equities, fixed income and high yield in particular are crowded trades.

Cross asset: expecting lower risk-adjusted returns

As said, we expect a smooth transition from an asset reflation regime towards a late financial cycle. 2018 will be characterised by Central Banks (CBs) progressively removing their excessive accommodation, smoothly reducing global liquidity conditions while maintaining accommodative financing conditions and eventually lower risk-adjusted expected returns. The regime we will move into could be unique and unprecedented for the macro and financial conditions described in the previous pages. As a result, risk/return combinations will be lower than for similar past late cycles

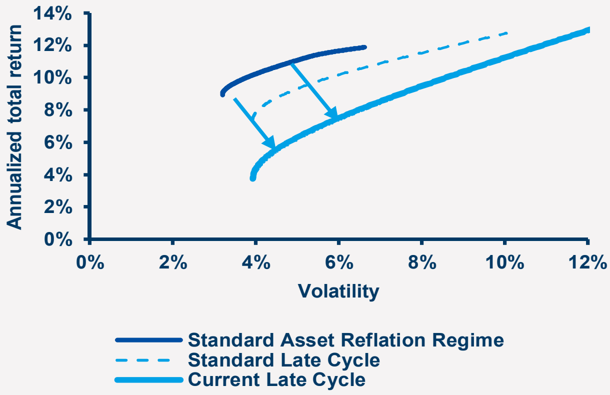
1/ **EPS growth 2018 projections**



Note: the chart shows Amundi Research's forecast yoy EPS growth for 2018. Consensus refers to the S&P500 website for US and FactSet for the other equity markets. Operating EPS S&P500, Eurostoxx trailing EPS, MSCI Japan LTM EPS, MSCI GEM EPS, and Stoxx Europe trailing EPS are considered for US, Eurozone, Japan, EM and Europe, respectively.

Source: FactSet, S&P, Bloomberg, Amundi Research (see the comparison with the "standard" late cycle frontier and the "current" one in the chart). In general, we expect volatility to increase moderately from the current compressed levels, but to remain on average low if liquidity provisions remain adequate.

2/ Efficient frontiers in different regimes



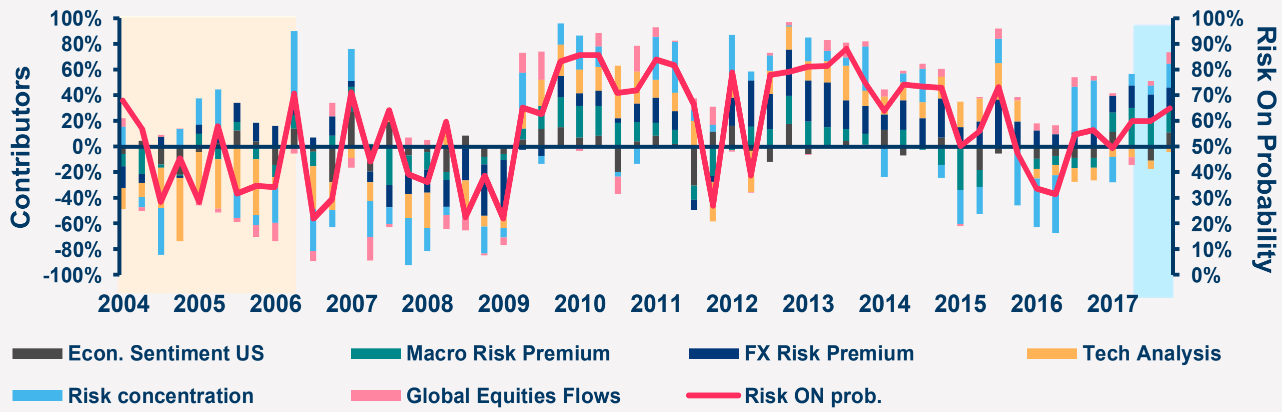
The Chart compares three efficient frontiers and plots the risk and total return profiles of 200 efficient cross asset portfolios (with different allocations optimised by volatility levels) for each frontier. The standard asset reflation frontier is calculated on historical average yearly returns and a covariance matrix specific to a previous asset reflation regime characterised by significant unconventional CB intervention (QE). The Standard Late Cycle frontier is calculated on historical average yearly returns and a covariance matrix during the Late Cycle regime. The Current Late Cycle frontier is calculated taking into account current bond and dividend yields. Asset class universe (local currency): US equities total return (S&P 500), US and Euro govies (JPM), US and Euro IG (ML), US and Euro HY (ML), GEM bond (JPM), US IL all maturities (Barclays).

Source: Bloomberg, Amundi Research

As a consequence, in order to enhance performance while keeping risk under control, in our view, it will be key to focus on selective opportunities and relative value trades (in preference to directional positioning) within and across asset classes.

In particular, from a cross asset perspective, **fixed income** is the asset class with a lower appeal. In fact, the risk attached to it when all our investment spectrum is considered is asymmetric: the expected gradual increase of interest rates will not be offset by coupons that are on average low. For these reasons, it is important that the asset allocation in fixed income is based on regional diversification and flexible duration management. CPI gaps and markets mispricing provide profitable opportunities in the inflation linkers space – in Europe in particular. Moving into the **risky assets**, a **rotation from HY into equity** is justified by the risk premium and the valuation reasons mentioned. The carry trade return component supports the case for **credit vs govies**, particularly where the CB purchasing programme offers good support. US and European companies are at different phases in their respective credit cycles. Our preference is for European investment grade, as there is no evidence so far of re-leveraging of non-financial European companies while leverage in US companies is very high.

3/ Amundi risk-on/risk-off indicator



Note: This proprietary indicator tracks risk sentiment and projects the probability of a shift between risk-on and risk-off regimes, and identifies the expected prevailing regime as the one with the highest probability. The indicator considers: the correlation among a risk-sensitive basket (S&P 500, VIX, Gold, JPY/USD and CHF/AUD); the Credit Risk Premium (Moody's calculation); the FX risk premium (BofAML calculation), the US Economic Sentiment Indicator (Citi Surprise index); technical analysis (Amundi calculation); and Global equities flows (State Street). The signal provides the probability of staying in a risk-on or risk-off regime. The expected prevailing regime is the one with highest probability.

Source: Bloomberg, Amundi Research

On fundamentals and valuation considerations, we favour **the equity markets of European countries, Japan and some relevant EM (in Asia in particular)**. In particular, Europe and the financial sector should benefit from rising interest rates and steepening of the interest rate curve, while Japanese companies should continue to benefit from a weak yen and the BoJ's equity purchasing programme. The most appealing equity region in EM remains **Asia,** with some interesting long-term stories based on improving internal and external conditions (China, India, South Korea, to mention the most relevant). At the same time, in such a mature phase of the cycle, an interesting equity theme to play is **quality with a focus on potential liquidity issues in an environment of (smoothly) rising interest rates**. For the same reasons, another important theme to consider is value in order to diversify regional equity allocation. **FX** will likely remain the most reactive asset class to CBs and to political noise while some trends are likely to continue (weak GBP, JPY). The USD should be considered for diversification and possibly hedging purposes.

Search for macro hedging

Expected higher volatility, unprecedented fixed income vulnerability, overcrowded fixed income trades, and a potential liquidity drain make the search for hedging a crucial factor in an environment in which inflation and/or rate surprises are flagged as major risks moving forward. 2017 stands as one of the longer lasting “risk on” periods relying on CB support. Moreover, it is worth noting how well balanced the contributions to risk on are at present, both from the real economy and the financial markets (i.e., economic surprises and macro momentum, credit and FX risk premia, safe haven asset class correlations). Moving forward, we expect this to change and more risk on/risk off switches to occur. In fact, during stress events, the interaction among risk factors usually tends to increase and the correlation between asset classes to lift while liquidity dries up. A good historical reference is 2004-2006, when the Fed became less accommodative (see graph below on the evolution of the risk on/risk off indicator).

In such an environment, the risk/reward profile has to be recalibrated, focusing more on limiting potential drawdown mainly through optionality, beyond traditional macro hedges, as they might not necessarily work (ie, the USD over the last year).

The risk of twin bear markets involving fixed income and equities with snowballing and painful effects on all financial and capital markets limits the set of potential and traditional hedging strategies and increases the cost of protections at the same time. Consequently, active hedging allocation management is worthwhile in the absence of a real diversifier, such as govies. In our view, liquid hedges, such as gold, and risk-sensitive cross rates, including the AUD/JPY, remain among the most effective macro hedging strategies in terms of costs and benefits.

CIOs' investment strategies: Q&A

MATTEO GERMANO, Head of Multi-Asset

Q1 / What are the key themes for multi asset investing in 2018, and how should investors play them?

We believe that in 2018 the key themes for multi-asset investing will remain broadly the same as in 2017, but with a different tilt and different implications on asset allocation. **Central bank asynchrony** will continue to unfold, with the Fed (and the BoE) on the tightening side, and the BoJ and ECB still broadly accommodative, but with adjustments likely. Therefore, investors should continue to reduce spread duration while maintaining credit exposure for carry trade reasons, and keeping average government bond duration short. In credit, investors should focus on IG vs HY, with a preference for the eurozone while it is still supported by the ECB's purchasing programme. We think inflation will be a key theme for 2018 amid a market that is sceptical in its expectations and commodity prices on a mildly rising trajectory. For us, this means favouring real vs. nominal rates with a focus on Japan, US and European inflation linkers. Another important theme we have identified is the **paradigm shift** (from monetary to fiscal policy). Regarding this, we believe investors should see more inflation catalysts to further increase the commitment to the performance laggards (Europe) that seem more sensitive to yield curve steepening. In Europe, financials could still offer opportunities, as the sector could benefit from the lack of interest rate steepening on the continent. A commitment to Japan should be maintained, with a progressive move towards a more selective approach in order to reflect the partial closure of the valuation gap and a positioning strategy which is less exposed than a few months ago. On EMs, we continue to see as beneficial a country-specific approach to identify stronger vs. weaker players and to take advantage of the different macroeconomic transition speeds. In our opinion, playing the entire EM complex seems like a potential mature trade in the presence of a strengthening USD and the perspective that rates will likely increase. Among EMs, we have positive views on South Korea and Russia given the backdrop of a solid macroeconomic situation. China is a theme investors should keep playing with a dual approach: as a relative value story, playing the progress of internal reforms and economic rebalances (New China vs Old China sectors), and given a directional focus, being aware of the increasingly stretched valuation conditions arising from the 2017 rally and macroeconomic variables that look to have peaked already but that remain supportive. We would suggest remaining liquid on quality names in EM bonds, preferring, when possible, carry trades in FX EM which look to be a more liquid proxy vs. cash bonds.

Q2 / What are the major changes that multi-asset investors should apply to their 2018 strategy compared to 2017 and why?

We believe investors should more intensively play country/sector/style and asset class/approach rotation during 2018. On style and sectors, we would focus on a rotation back to value in case of positive inflation and term structure evolution (steepening). On asset classes, we would look at a rotation towards equity vs. HY, which is experiencing a leverage increase back to 2008 levels and now appears vulnerable to interest rate rises (especially in the US). In terms of investment approach, we would focus on a rotation towards relative value trades to exploit different speeds in economic and policy adjustments, with a stronger focus on measures to tame rising volatility, liquidity and credit risk. On equity, our strategy would mean progressively replacing cash equity with an asymmetric option strategy, where we are keen to give up some participation in exchange for more protection.

Q3 / What are the main issues/events to watch during the year and why?

We think one of the key variables to look at will be US short-term real rates (see chart). This variable is extremely important as a barometer for the correct functioning of a leveraged credit market (HY more than IG in the US) and of equity markets. The US equity market has been largely driven so far from buybacks that seem to dry up when credit markets experience difficulties.

Outside the US, we believe it will be important to monitor producer price index (PPI) dynamics in EMs – more specifically, in China – because they can help in understanding price dynamics in DM as well. We monitor EMs' equity resilience, which critically depends on the level of the US dollar and ample liquidity.

Q4 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

In this last phase of 2017, a wave of limited inflation printing and cautiously dovish news from central banks have to a large extent favoured a further flattening of yield curves, preventing real rates from continuing to see a rising trend. Oil prices have been rising, but without noticeable effects on inflation expectations as measured by breakeven rates. In this environment, some equity markets, such as those in Europe, which are highly exposed to financials and industrials, have slowed more vs Japan and the US. European equities and financials specifically can deliver positive surprises if and when a mild but steady reflation process will be back in focus, driving the long end of the yield curve higher. We expect this to be in focus in 2018 with an increasing likelihood of seeing a transition to a late cycle. Among the risks not priced in by the markets, we would mention liquidity and credit risk.

These are clearly connected to each other, and both are associated with very low volatility. Structural changes in liquidity providers with banks deleveraging their balance sheets are largely untested, with investors' portfolios still extremely long income-seeking positions. A faster-than-expected increase in real rates could generate a market selloff in a fragile environment in which risks and asset classes will likely prove closely interconnected.

Q5 / And what strategies should investors apply to mitigate risk in 2018?

A rise in volatility from extremely suppressed levels seems likely in a year of contractions in central bank balance sheets and rising rates (the Fed). We expect to see a resurgence of liquidity as well as – especially in the US – credit risk. To mitigate this risk, investors could use different strategies: raise the liquidity profile in their portfolios; improve the average credit rating; maintain a commitment to a risk on stance, but progressively adopt option structures rather than cash equity; implement hedging strategies.

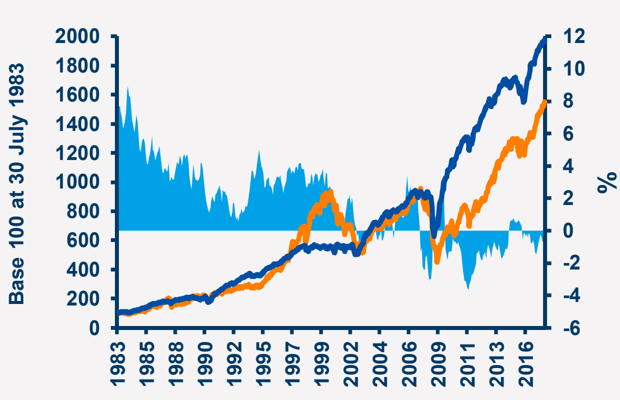
On hedging strategies, we believe that gold could work well when real rates dynamics give mixed signals regarding asset reflation vs the late cycle. The AUD/YEN could prove to be an efficient hedge if China were to start showing signs of a slowdown in growth and a PPI reversal. We would continue to play the USD/EUR as a safe haven in case of a market selloff or to counter geopolitical risks. We believe that at the current level of spreads and leverage, some hedging strategies on US HY spreads could be helpful in case of a market selloff.

Leveraging on the outcome of our Internal Risk Survey that compares the probability of occurrence and the impact on the implemented strategies, we believe investors should hedge the following risks:

- Market sell-off;
- Synchronised normalisation of Central Banks leading to lower liquidity, initial spread widening and a cross asset sell-off;
- Geopolitical tension from Brexit to Middle-East and North Korea/China/USA.

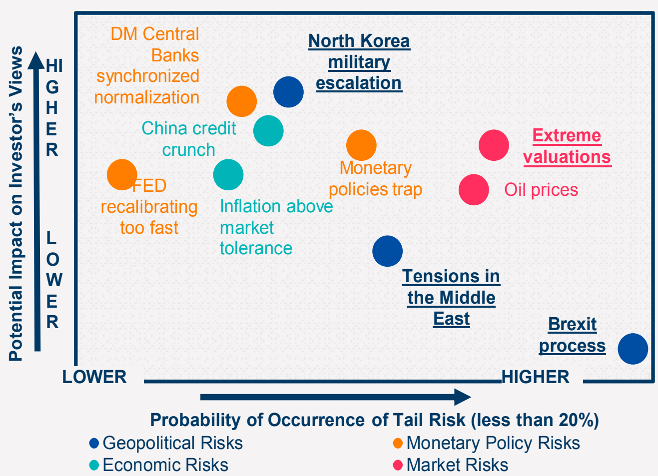
RISK	MARKET IMPLICATIONS	LIQUID MACRO HEDGES
• Boom bust bubble (i.e., market sell-off)	• Sentiment reversal initiates a decoupling of fundamentals and asset prices whose dynamics are magnified by heavy out of equity re-positioning (mainly from ETFs)	• Equity & FX optionality (AUD and JPY)
• Synchronised and too fast normalisation	• Lower liquidity, spread widening, fixed income sell-off, competitive devaluations and GEM asset classes under pressure. EM (bonds) outflows	• Optionality (CDS (HY)
• Geopolitical Tensions	• From regional (Brexit, Middle East) to global (North Korea/USA/CHINA)	• Long gold

1/ US real short-term rates, US equities and US HY



Source: Bloomberg, Amundi Research. Data as of November 10, 2017

2/ Amundi Top-Down Risk Matrix



Source: Amundi Research. Data as of November 10, 2017

Underlined risks are those hedged by Multi-Asset. Diversification does not ensure a profit or protect against a loss

Disclaimer

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